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India's Dabhol Power Plant Controversy: Actors and Motivations [redacted]

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India's Dabhol Power Plant Controversy: Actors and Motivations [redacted]

Summary [redacted]

The Dabhol Power Corporation (DPC) project to build a 2,184-megawatt (MW) power plant in the Indian state of Maharashtra is a remnant of the effort by the Government of India in the early 1990s to solve its electric power sector challenges through the private sector. The project has had a stormy history since the original agreement was signed in 1993, including a renegotiated contract in 1995 that failed to put to rest charges of price gouging and suspicions of corruption, or allay fears over foreign ownership in India. [redacted]

The trigger for the current crisis is the calculation by the Maharashtra State Electricity Board (MSEB)—DPC's sole customer—that it will not be able to afford all of DPC's power when the 1,444-MW of phase II completes the project in June this year. Beginning last November, MSEB stopped paying its bills to DPC in an effort to force the central government to become involved and provide relief. [redacted]

The attempts of the parties to resolve this business problem are dogged by a complex tangle of competing policy and political goals of the actors involved. On the political front:

- DPC's long history as a lightning rod for anti-foreign and anti-multinational corporation sentiment makes it difficult for either the state or central government to deal with DPC without attracting charges of "selling-out" to foreign interests or bowing to US pressure.

- Rival political parties lead the central and state governments, and each seeks to derive political advantage from the situation. The central government has a long history of allowing states led by opposition parties to be overwhelmed by a crisis before intervening. [redacted]

On the policy front:

- New Delhi is trying to instill fiscal responsibility in the states by resisting appeals for bailouts. The center wants to avoid setting a precedent that it will be the purchaser of last resort when states run into trouble with their private power projects.

- India's central bank and Ministry of Finance bureaucrats now expect commercial and development banks to meet international standards of creditworthiness–a shift away from their earlier practice of using these institutions to support and subsidize favored industrial projects.

- New Delhi values what it perceives to be warming relations with the US and wants to avoid anything that might weaken this trend.

- New Delhi and Mumbai both reason that the controversy surrounding the DPC has been so well-publicized and has persisted for so long, that it is unlikely to affect other potential foreign investors. However, both know that extended and acrimonious negotiations will not help either's long-term reputation and could complicate efforts to attract large foreign investors in the future.

With MSEB and the Government of Maharashtra perceiving that their financial backs are against the wall, the outcome of the controversy rests ultimately with the central government. This report outlines the political economy of Maharashtra and the electric power sector, identifies key decision makers and their motivations, and examines the financial relationships between the center and the states.

India's Dabhol Power Plant Controversy: Actors and Motivations [redacted]

Maharashtra: Ruling Government Grappling with Challenges [redacted]

Maharashtra Chief Minister Vilasrao Deshmukh of the ruling Democratic Front (DF) government has maintained a fairly secure hold on power since coming into office 18 months ago after cobbling together a coalition led by his Congress Party and the Nationalist Congress Party (NCP). The Front remains united largely by its common rejection of the opposition, a shared reform agenda and a good working relationship between the Congress Chief Minister and NCP Deputy Chief Minister but significant challenges remain.

- The Shiv Sena/Bharatiya Janata Party (BJP) alliance, which ruled the state from 1995 to 1999 under Sena leader Bal Thackeray, is the main opposition to the Front. Voter disenchantment with failure of the Shiv Sena/BJP government to deliver on promises, blatant corruption and the ballooning of state deficits contributed to the Front's victory during the 1999 state assembly elections. [redacted]
- The Deshmukh government has taken several steps forward on social and political issues, including the reestablishment of protection for minority rights—which were widely believed to have suffered under the previous government—education reform and devolution of spending and decision-making authority to local service sectors. [redacted]

Despite these accomplishments, Deshmukh faces pressure to live up to the expectations of voters and coalition members. District elections across the state this summer will be a benchmark for gauging support for the government.

- [redacted] outside of the wealthy business classes in Mumbai and other large cities, voters in the state view government as the provider of basic services. Politics tends to be driven by local issues affecting daily life—such as road improvements, water projects and the like—and caste, religion, and personality figure prominently into voter preferences.
- Deshmukh has juggled his cabinet membership, driven by a mixture of politics and policy. In March he removed several outspoken ministers who were critical of his policy initiatives and promoted others who were threatening to defect to the opposition. [redacted]

Personal rivalries within the Congress Party factions also complicate the political environment in the ruling coalition. The NCP is a splinter group of the Congress Party which has emerged in its own right as a national party under the leadership of three-time former Maharashtra Chief Minister Sharad Pawar.

- Pawar has advocated for the reform of the Maharashtra State Electricity Board and has generated significant attention for his "pro-Enron Project" stand, according to press reporting.
- Pawar's appointment to a key position at the national level has raised speculation among political circles whether the NCP is moving closer to the BJP, although ideological differences makes any formal alliance between the two unlikely. [redacted]

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The opposition Shiv Sena often takes contradictory but politically expedient stances on issues to attack the Deshmuk government. In April, for example, the Shiv Sena participated in a general strike to protest the "anti-labor" policies of the state and central governments and to press for cancellation of the Enron project, even though the party approved the project when it was in power.

- Despite being traditionally critical of foreign investment, Shiv Sena leader Uddhav Thackeray encouraged a bipartisan approach to working through the Enron dispute last December, [redacted]

Maharashtra: Economic Overview

Maharashtra is India's second most populous state with 96.75 million residents (nearly three times the size of California), and is third in size at 118,809 square miles—slightly larger than Arizona. The Mumbai metropolitan area comprises 18.6 million people and is India's largest city. Maharashtra ranks fourth among states with 77 percent literacy, above the all-India average of 65 percent. Female literacy, at 68 percent, is well ahead of the national average of 54 percent.

Maharashtra's gross domestic product in fiscal year 1999-2000 was $55.4 billion—accounting for 14.7 percent of India's gross domestic product (GDP) and making it the largest state economy in India. Per capita GDP in FY 99-2000 was $573, above India's average $455. Sectoral shares of GDP have remained stable throughout the 1990s, with services at 44 percent, industry at 35 percent, and agriculture at 21 percent. Roughly 70 percent of the state population is employed in the agriculture sector.

In the 10 years since India began economic reforms, Maharashtra has been a leading destination for investment and industry. Maharashtra has attracted 41 percent of the $10 billion in foreign direct investment that has gone to India since 1991, and leads the rest of the country in domestic investment, with 21.7 percent of all approvals from 1991-2000. With 11 percent of India's industrial units and 23 percent of all industrial output, Maharashtra has had success in chemical, petroleum, plastic, textile and steel industries, and, in 1999, led the nation in production of sophisticated electronics, pharmaceuticals, and computer software.

Business and industry have flourished in Maharashtra due to the state's many advantages:

- Maharashtra possesses a large pool of educated workers.

- Mumbai is the home of India's two largest stock exchanges, the Securities and Exchange Board of India (SEBI), the Reserve Bank of India, and other major financial institutions.

- Maharashtra is ahead of most states in infrastructure with 200,000 km of paved roads, 13,000 MW in power generation, 11,000 km of fiber optic cables, two of India's largest ports, and reliable transportation networks.

Although Maharashtra has been far ahead of other states throughout most of the past decade, its economic advantages over other Indian states have been eroded by a combination of complacency and competition from the rapidly growing southern states of Tamil Nadu, Karnataka, and Andhra Pradesh.

- Although Maharashtra's infrastructure is good by Indian standards it is not world class and modern businesses complain about the state's inefficient power transmission and distribution system, and poorly maintained roads.

- In contrast to the rising southern states, Maharashtra's political leaders have not been as aggressive in seeking out investment opportunities, often waiting for interested parties to seek opportunities there instead.

- Maharashtra's highly bureaucratized administrative system, repeated policy changes, arbitrary taxation, costly power, water, and land resources, and less-attractive subsidy packages for businesses have also contributed to companies deciding to locate in more business-friendly environments.

The current government led by Chief Minister Vilasrao Deshmukh has tried to remedy the situation following the US Presidential visit to Mumbai in March 2000. Deshmukh came to the United States in the summer of 2000 to woo investors. The government has since instituted the "Maharashtra 2005" reform plan, which aims to increase per capita income from around $500 to $2172, boost the state's annual economic growth rate from 8 to 10 percent, and reduce the poverty rate from 36 to 15 percent by 2010.

Maharashtra's fiscal health is in poor shape, however, as reflected in the recently released 2001-2002 state budget, which totaled $7.15 billion. Over the past year, the state's revenue deficit has increased by 46 percent, to an estimated $1.3 billion dollars. Promises of a 50 percent reduction in fiscal deficit this year have been met with skepticism—particularly since it failed to reach last year's modest 7 percent target. [redacted]

Indian and international economic analysts remain concerned by the state's slow power sector reform and lack of a viable plan to reduce the fiscal deficit. These problems are compounded by the fact that 30 percent of Maharashtra's revenue is devoted to servicing and repaying state debt. In addition, in February 2001, two Indian credit rating agencies downgraded the State's credit-worthiness rating four levels to "speculative," in response to Maharashtra's failure to fulfill its contractual obligations to the Dabhol Power Corporation when the Maharashtra State Electricity Board defaulted on a monthly payment. [redacted]

The Indian Electric Power Industry in the Post-Fast Track Environment

India's Power Situation and Needs. India has about 113,000 MW of installed electric capacity, but suffers widespread brown- and blackouts. The Ministry of Power estimates India is about 10 to 15-percent short of capacity and expects the situation to get worse over the next several years. GDP growth at the targeted level of 7 percent per year requires that India increase capacity by about 10 percent each year. The Central Electricity Authority (CEA) estimates that India will need to add over 100,000 MW of generating capacity by 2012, but capacity growth has averaged just under 4,500 MW per year since 1996, well below what is needed.

India's power needs are far beyond the ability of the central and state governments to pay. New plants cost an estimated $1.1 million per megawatt. Annual investment therefore needs be about $10 billion per year. Central government revenues from all sources except borrowing are only about $50 billion, over half of which is taken up with defense and interest payments on the national debt. State governments are in worse shape, relying on grants and loans of about $11 billion each year from the center to stay afloat financially.

"Fast-track" Projects Era. Shortly after the economic reforms of 1991, the center pinned its hopes on encouraging the private sector to build new capacity. The initially weak response of potential investors forced the government to recognize several structural weaknesses in the industry—a result of decades of government ownership and control—which needed to be addressed before the sector could attract private investment. The problem of ensuring payment was—and remains—especially acute.

- The usual customer for a private power producer is the local State Electricity Board (SEB). All of the SEBs in India operate in the red and most are insolvent. Contractors—foreign and domestic—have encountered serious difficulties raising funds from banks and other financial institutions over concern that the SEBs will not pay the contractors who will then be unable to repay their loans.

- The SEBs are insolvent because political interference from state politicians has forced setting of power tariffs far below costs—or even provided freely—to privileged groups such as agriculture and household consumers. Power authorities also often turn a blind eye toward power theft by both the poor and the politically well connected.

To circumvent the SEB problem and create some success stories to encourage follow-on investors, the central government offered to guarantee payment for eight power projects. But the issuance of these so-called "counterguarantees" was only an expedient, and New Delhi knew early on it could not fund all of its power needs in this manner.

- SEB defaults—all too likely, in the views of the government and international investors—would force New Delhi to drain its foreign currency reserves to make good on its guarantees to foreign contractors. The potentially costly counterguarantees would, in turn, harm India's international credit rating.

- Current Indian government policy guarantees only the foreign loan portions of existing projects and does not issue guarantees for new projects.

- Moreover, the fast track program was not the resounding success New Delhi had hoped. Some projects never received their counterguarantees, while some of those that have—such as Enron and Cogentrix—have run afoul of local political or environmental interests.

The center also tried to encourage private investors by transferring substantial project approval authority from the center to the states. To expedite projects, New Delhi in 1995 delegated to the states authority to give environmental approval in all cases, and authority to approve new projects below 250 MW and renovation and modernization projects for existing plants. As a result, there was a plethora of plans, projects, and memoranda of understanding at the state level—so many that the World Bank and others expressed concern that a "gold-rush" mentality had set in which would result in numerous project failures and haphazard development. Their fears were borne out in February 1997, when over 100 projects in several states were scrapped because promoters had failed to secure the proper agreements and financing by set deadlines. [redacted]

Subsequent Initiatives. The Indian government has tried to address the problems of the sector that were highlighted by the "fast-track" program, but progress has been agonizingly slow. In December 1995, New Delhi announced that the Chief Ministers of the states had agreed to a coordinated program of restructuring the SEBs; unbundling generation, transmission and distribution; and rationalizing tariffs. In particular, the practice of providing agriculture with cheap or free power would be curtailed and a minimum of .5 rupees per kwh—about one-third the average cost of generation—would be charged the agricultural sector. Implementation of the agreement has been unsatisfactory, however. Although fourteen states have established State Electricity Regulatory Commissions (SERC), which are intended to set electricity tariffs without political interference, there has been little progress on the key issues of metering and charging realistic rates. [redacted]

The central government renewed its attempt to press the states to reform the SEBs in the spring of 2001 with another Chief Ministers meeting—where they again pledged to carry out 100 percent metering by December 2001 and charge all users—and a new plan that linked substantial financial incentives and penalties to SEB reform. Power Minister Prabhu told reporters, however, that until SEB reform had progressed to the point were private investors were willing to deal with them, the public sector would have to carry the brunt of the country's electric power capacity expansion. [redacted]

[redacted]

[redacted]

The Indian Lender's Perspective [redacted]

Indian financial institutions with exposure to the Dabhol project respond to guidance from the Reserve Bank of India (RBI) and to their own commercial interests. They interpret their commercial interests from the perspective of their ongoing restructuring away from government support and management and, except for IFCI, toward their expected role as effective players in a competitive financial sector. [redacted]

Of the five major Indian lenders, only ICICI is not directly or indirectly owned by the Indian government, but the Ministry of Finance does not usually have an active role in decisions about making or restructuring individual loans. The institutions do sometimes meet with Indian ministries to discuss the financial feasibility of policy approaches, but appear able to resist arrangements that would jeopardize their own creditworthiness. [redacted]

The RBI and Ministry of Finance bureaucrats no longer view the development banks as channels for supporting and subsidizing industrial projects. Moreover, the RBI probably would intervene informally to help the commercial and development banks resist any central government pressure—which is not evident so far—to increase support for an unviable foreign project. [redacted]

The policy environment and the business plans of the Indian lenders suggest the following priorities during negotiations about restructuring or closing the Dabhol project.

- The institutions will expect to meet their guarantee obligations to international lenders once the legal obligation to do so is clear. They will not want to jeopardize their own credit standing on international payment obligations. The RBI will share this view.

- The lenders will be very reluctant to assume any additional exposure to the Dabhol project or other energy projects that sell to SEBs – but would be less concerned about having to treat their existing loans to the Dabhol project as nonperforming.

- Because the financial institutions' security for their loans is in mortgages on the Dabhol properties, they probably want construction of the liquefied natural gas (LNG) facilities to be sufficiently complete to leave a useable asset that could be sold if buyers for gas can be identified. IDBI's recent moves to stall a preliminary termination notice may reflect this concern as well as its willingness to gain time for Ministry of Finance officials to develop an Indian government position.

- The Indian lenders probably would not support operation of phase 2 of the project—use of LNG imported under long term contract—unless willing buyers with funds can be found for the additional electricity. They might prefer a quick settlement, even at a one-time loss, that would permit sale of assets and recovery of part of their losses. After Dabhol stops interest payments, the institutions will want to avoid protracted legal wrangling.

- If the RBI approves, the institutions would be willing to reschedule some of their own loans to the project to reflect their own lower borrowing costs. RBI approval seems likely if Dabhol negotiations are viewed as an effort to prevent bankruptcy and maintain operation of part of the project.

Background on Center-State Financial Relations [redacted]

Under the federal relationship established in the Indian Constitution, taxes and duties collected by the Central Government are shared with the states. In addition, the Constitution allows for funds to be apportioned to states in the form of grants and loans.

- A state's share of taxes, duties, and levies is determined by an independent Finance Commission, which must meet at least once every five years. This share represents a large portion of many state government budgets—and was 8 percent of the funds available to the Maharashtra government in 1999-2000.
- The central government provides grants and loans to help states meet the cost of their "Plan" spending on development and welfare. These funds are allocated among the states according to a formula based on population, per capita income, and performance.
- In addition, the central government provides funds for its own projects and centrally-sponsored projects, some of which are implemented by state governments. The central government has considerable discretion in allocating this support among the states. [redacted]

A Glance at Maharashtra's Revenue (2001-2002) [redacted]

Total	*$7.15 billion*
Share Central Taxes	*$617 million (8.6%)*
Grants in Aid	*$418 million (5.8%)*
Loans from Center	*$1.07 billion (15%)*

Implications for a Restructured Project [redacted]

Under the terms of the central government's current counter-guarantee of payments to the Dabhol project, any "bailouts" the Center might provide would be deducted from the central government support for Maharashtra Plan spending on development and welfare. [redacted]

New Delhi could support Dabhol phase II through an expanded counter-guarantee agreement—i.e., if MSEB and the Maharashtra government default in payments for electricity available from full operation of the project, New Delhi would pay and deduct an equivalent amount from central support for the Maharashtra state Plan. Or, a public-sector organization could acquire equity in the project and New Delhi could then provide support as part of the central government's own Plan spending. Or, less likely, New Delhi could agree to deviate from the formula that allocates support for state government plans and provide additional funds for Maharashtra.

- In the 1999-2000 budget, approximately 4 percent of the $17 billion Plan expenditure was allocated to Maharashtra. The Center's fiscal budget allocates $20 billion in Plan expenditure in 2001-2002, of which approximately $1 billion is slated for development in Maharashtra.
- Approvals for projects requiring additional assistance are judged on an ad-hoc basis, upon recommendation by the Planning Commission, which must also approve such financial transfers. [redacted]

The Central Government has demonstrated budgetary flexibility over the past several years when propping up favored state governments or programs through off-budget measures and creative financing, leaving open the possibility that extraordinary funding for Dabhol could be available if essential to a satisfactory resolution to the problem. However, it would take a determination by the highest policy levels of the Indian government that such an action would be in the national interest. [redacted]